RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P.O. Box 1759, La Jolla, California 92038
36 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

February 4, 1977 **LETTER 688**

Jan. 21, DJIA 962.43; PTI 826; A-D Ratio –18.94
Jan. 28, DJIA 957.92; PTI 824; A-D Ratio –19.21

LET'S FACE IT: It's becoming patently clear that the Carter Administration is tuned into deficits and "making jobs," not capital markets, balanced budgets and business profits. Obviously, the current economic situation isn't Jimmy Carter's fault, but the current direction of Government most definitely reflects Carter's thinking. With this in mind, I am presenting the following section on "insurance." Please read it carefully.

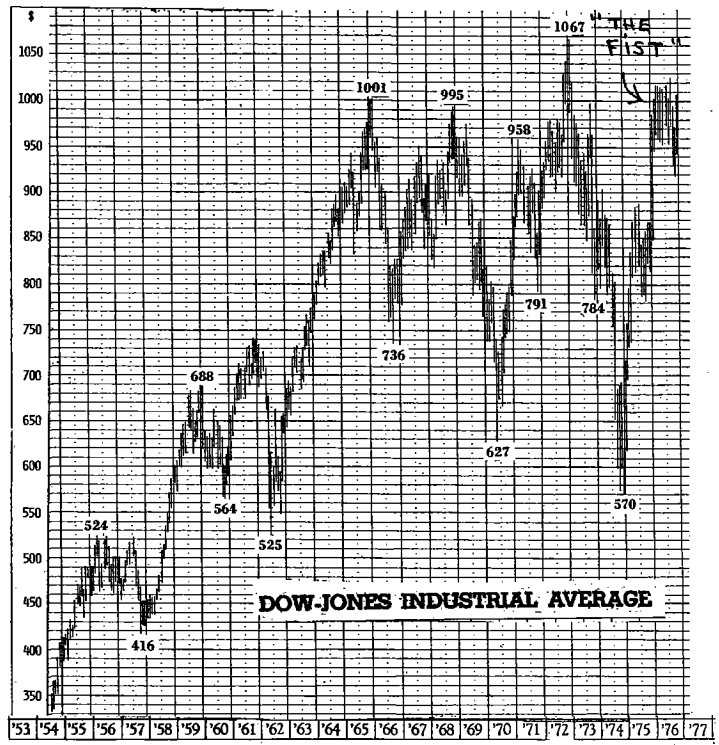
INSURANCE: Those who have followed my writing over any length of time know that I always believe in taking out "insurance" against possible disaster. Anyone can have opinions, preconceived notions, brilliant scenerios and what-have-you regarding Wall Street and the economy. But wise men know that the market always, always has ***the last word***. The graveyards of the securities business are littered with the corpses of those who insisted on arguing with the market. I don't intend ever to be in that category. Nor do I want any of my subscribers, not a single one, to find himself or herself in that situation.

I am listing a few "insurance" spots, which if touched off, will serve to warn us, you and me, that the market is moving into potentially dangerous territory. When I say "dangerous," I mean the unknown, the place where the market is leaving my own bullish scenerio.

(1) Obviously, the lower the Averages go, the nearer the market is to at least a temporary "over-sold" condition. Nevertheless, I would **not** care to see Industrials and Transports break their last secondary lows. Those lows were **924.04** for Industrials (Nov. 10), and **203.85** for Transports (Oct. 12). A closing with **both** Averages below those points would be **my signal** to reduce common stock portfolios to a **low percentage**.

(2) The 13-week moving average of the Dow broke under the 50-week average of the Dow on the week of November 26. This bearish juxtaposition was duly noted here at the time, but I stated that it is my policy to give a bull market "every benefit of the doubt." On January 7, the spead was 20 points between the two moving averages (MA's) with the 13-week still in the bearish position below the 50-week. As of this week the bearish spread had contracted to 16 points. However, if the spread expands to a new high of 21 points or more, I'm not going to like it, and I am going to recommend that we take out insurance.

(3) The phenomenon that has kept me hopeful regarding the near and intermediate term outlook for this market has been the incredible performance of the Advance-Decline Ratio. A "buying stampede" began on October 25, 1976, and by January 3, the A-D had gained exactly 5.37 points. I term it a buying stampede if the A-D rises 5 or more points without so much as a 1 point intervening correction. As long as the A-D ratio refuses to give up 1 point (regardless of what the Dow is doing) I am willing to sit tight. I am willing to do this because the A-D is telling me that technically, the buying stampede *is still in force*, and that losses during a continuing buying stampede have to be minimal. However, if the A-D breaks over 1 point I would say that subscribers



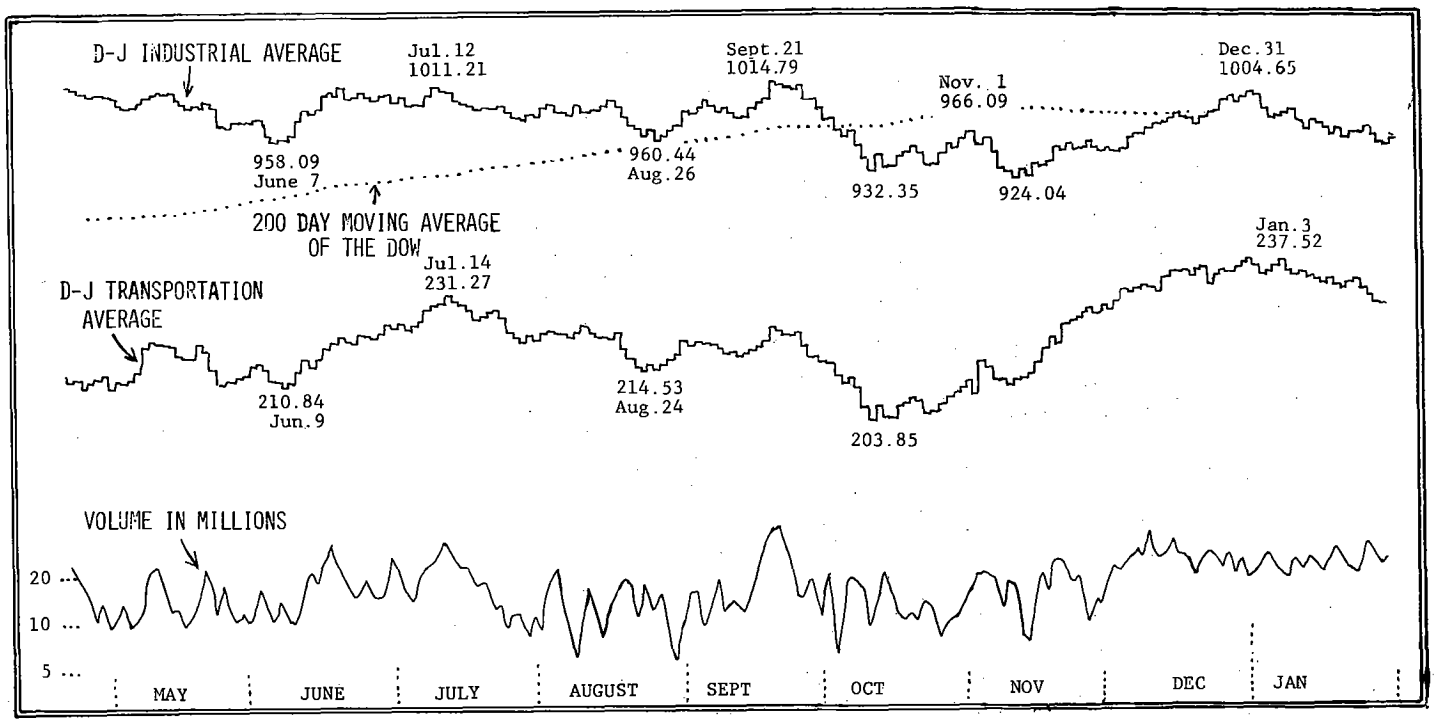
should be very careful, probably scale back on some stock holdings, **start** to move into a defensive position.

(4) The "market" has done very little over the last year. On a long-term chart (monthly chart courtesy of *Horsey*, Salisbury, MD 21801) the Dow looks as if it has formed a tight "fist" following the rising spike of 1975. But it is well to remember that big moves come out of long periods of inactivity, just as periods of great activity usually give way to market dullness. IF this market starts heading down, I want my subscribers to be protected. I don't want anyone calling to say, "Why didn't I listen," or "I figured that it had to go up," etc.

(5) My guess is that a big, even violent movement should result from the year-long period of "the fist." Because this is a bull market, the odds favor the move being up. But those are odds, not guarantees.

Note: I wrote all the above after a great deal of thought and bed-tossing. Treat it as a separate part of the Letter. Consider it an insurance policy that overrides everything else in this Letter. I've stayed in the advisory business for 19 years because I have always provided insurance policies when I think they are warranted. And I've lasted because I accept the fact that the **market itself** knows more than Richard Russell and the entire advisory service taken together!

THE PICTURE: When the market is talking, we always have two choices: we can listen, or we can ignore it. I always prefer the



former. So the only question now is–"What is the market saying?"

We know that the D-J Industrial Average struck its bull market high on September 21 at 1014.79. We know that the D-J Transportation Average recorded its high three months later on January 3, at 237.52. We know that the Advance-Decline Ratio also hit its bull market high on January 3. And finally, we know that the D-J Utility Average established a bull market peak on January 25 at 111.87.

Now let's see if we can unravel the puzzle that the market has presented to us. The new high in Transports unconfirmed by Industrials presents no great mystery. Very simply, the non-confirmation sets up the technical prescription for anything from a mild decline to a major correction. We are already in the midst of a decline. While the Industrial Average may yet turn up and confirm the Transports, it has not yet done so. That's the ***fact*** of the situation.

At this time, however, it's the ***breadth-price relationship*** that particularly interests me. The fact is that it is very unusual to see a new bull market high (or even an important new high) in the A-D ratio which is not confirmed by the Industrials. In past history, I find only three important examples of this syndrome. These three instances are well worth examining at this time.

The first example occurred in **1934**. The Dow and the A-D recorded bull market highs in February, 1934 (during the second year of the 1932-37 bull market). Following a decline, the two indices rallied again, and in April the A-D struck a new high, unconfirmed by the Dow. That technical failure led to a reaction which carried into September, 1934. When the market finally bottomed out in September, the market turned up for a major rise which lasted for 2½ years.

The second example occurred in **1947**. Highs were recorded on the Dow and the A-D in July. A decline ensued, and a new rally then took the A-D to a new unconfirmed high in October. This technical failure was followed by a decline into February, 1947. Next a shallow new slide took the market to a June, 1949 low. That low proved to be the base for a major bull market.

The third important example occurred in **1953**. Peaks were recorded by the Dow and the A-D during January. Following a decline, the A-D pushed to a new high in March, but the high was unconfirmed by Industrials. This technical failure brought on a reaction which carried into September of that year. When the reaction was over, the market turned up and entered a major and extended advance which did not end until 1956.

It should be noted that none of these three instances were associated with the beginning of a major bear market. Two of the instances (1934 and 1953) were followed by massive advances in price and breadth. The other instance (1947) was followed by a four-month advance, and then a one year decline that ended with a base for the greatest bull market in history (i.e., 1949-66).

It is of interest that during the bear market of 1966-74, there were no examples of breadth peaks unconfirmed by the Dow. This suggests that one characteristic of primary bear markets is persistent weakness in the A-D, puntuated by major collapses and sharp rallies in the Dow. But the upward corrections in the Dow are almost never confirmed by the A-D.

The reverse side of the coin is this: primary bull markets are characterized by powerful advances in the A-D. At times, new highs in the A-D are not confirmed by the Industrials. These situations, while seen only within bull markets, can nevertheless be followed by reactions or long periods in which the market is stalemated.

Alright, what can we expect now, based on the evidence of the three aforementioned cases? It is probably coincidental, but following the 1934, 1947 and 1953 breadth-price non-confirmations, each of the ensuing reaction lasted five months before hitting bottom. If history were to repeat exactly, we could expect the current period of adjustment-reaction to carry into June of this year.

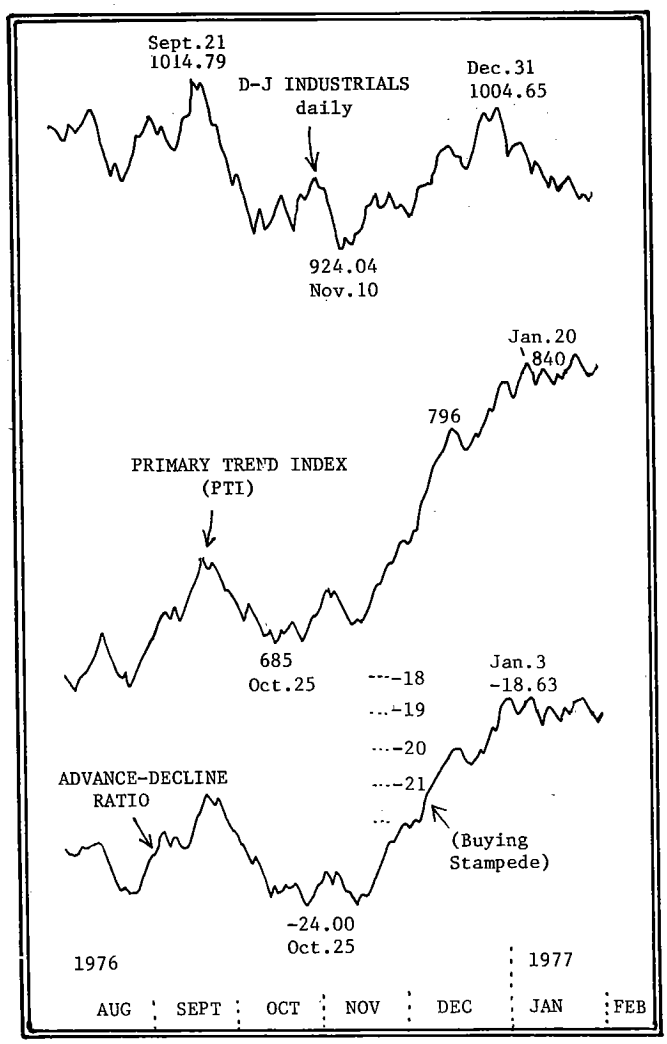
A reaction or irregular and frustrating period lasting to June would not surprise me at all, and it fits into my previous guess

that the first half of 1977 would be "reactionary," and any real upside action would probably start during the summer or during the second half of 1977. This, of course, is the opposite of what was widely expected during late-1976, when the consensus was that "the market is going to take off as 1977 opens, and it is probably going to hit a 1100 Dow top in the early months."

Question: Russell, let's be honest. Didn't you think that following a sell-off during say January-February, there was a chance that this market would move up to new highs? Now you're talking about a possible reaction into summer. Have you changed your mind?

Answer: I have felt (since December) that the key to the market was the performance of the Dow as compared with the A-D ratio. Regardless of the Dow slide since January 3, the A-D ratio was continuing to put on *an extraordinary performance in that it refused to break a full point from its January 3 high.* In fact, as I write this the market is down, but the A-D is still within 1 point from its bull market peak (I will have to update this on page 6 of this Letter, just before I close).

If the A-D can hold within the 1 point zone, then ultimately the Averages will get in gear with the A-D on the upside. If the reverse happens, if the A-D breaks the full point, then there could be trouble. As I have written before, something strange (almost mystical) happens, following a buying stampede, when the A-D drops a full point or more. It's as if the "oomph" just goes out of the market. Whatever strength has been retained in the technical situation seems to fade away.



The longer the A-D holds in the current 1 point (from the top) zone, the more importance I give to the eventual breakout. If we move out to a new A-D high and the Averages follow, then I would think we could see a real surprise with sudden, "extraordinary" market strength appearing.

On the other hand, if the buying stampede officially ends via a 1 point drop in the A-D, then the majority of issues will be starting to confirm the weakness in the Dow. Such action, I would think, could lead to a pretty deep correction with the October Dow low of 924 being tested.

I must say that in all my experience I have not seen a situation in the price-breadth relationship comparable to this one. I have never, in all the years that I have been watching the stock market, seen the A-D hold to 1 point while the Dow gave up over 50 points. There's an absolutely extraordinary battle going on in the stock market, and I can almost sense the great giants fighting in the murky unconscious of Wall Street. The outcome should be something to see. I know there's something "big" happening out there. I know it, but its meaning is beyond my understanding at the moment.

Question: What do you make of the falling glamor stocks? What is this telling us about the picture ahead?

Answer: I have said all along that this phase of the bull market will be based on *values* and *yields*. This is almost always true of the first and second phases of any bull market. But there is another consideration today. In recent Letters, I discussed the "limits of growth" thesis. In Letter 686 I wrote about Peter Drucker and the concept of "a shrinking US pie." The fact is that we are moving into an era of shortages of materials and very probably shortages of capital. We are also moving into a new situation in which price rises (for instance, oil price rises) are going to have deflationary effects in that rising prices are going to bring on lowered demand.

The crux of the glamor-growth stock boom was the "uncertainty' of ever-rising demand and ever-rising sales and profits. Such thinking is no longer valid today, in my opinion. And the glamor stocks are coming down accordingly. A worried portfolio manager called me last week and said, "They're just knocking the hell out of the glamor stocks Disney, McDonalds, Burroughs, I mean what's going on? This thing is beginning to scare me, it's crazy. Where do you think these stocks are going Russell? How low are they going to go?" My answer was that they are simply going to sink until they become *values*, based on current earnings and yields rather than on hopes and expectations.

The fact is that the real guts of this bull market has been the great advance in the mass of stocks that had been pulverized by the 1966-74 bear market. In 1974 the stock market was in shambles with the average stock selling at below value, below book, below anything seen since 1949. At present there are still hundreds of NYSE and AMEX issues selling at 3-6 times earnings, stocks with long dividend records, stocks which are selling near or below book value. Stocks which are yielding 6-9% *now*.

Wall Street is looking at the prospects for a no-growth economy. It is looking at glamor stocks that still yield 2%, 1% and less, it is looking at the vulnerability of such stocks in a relatively

static economy, and it is saying, "out." Wall Street is turning to values, yields, low-priced stocks that are not "cheapies" but priced low because they are under-valued. Wall Street has decided that it would rather have a value in the hand than a concept in the portfolio.

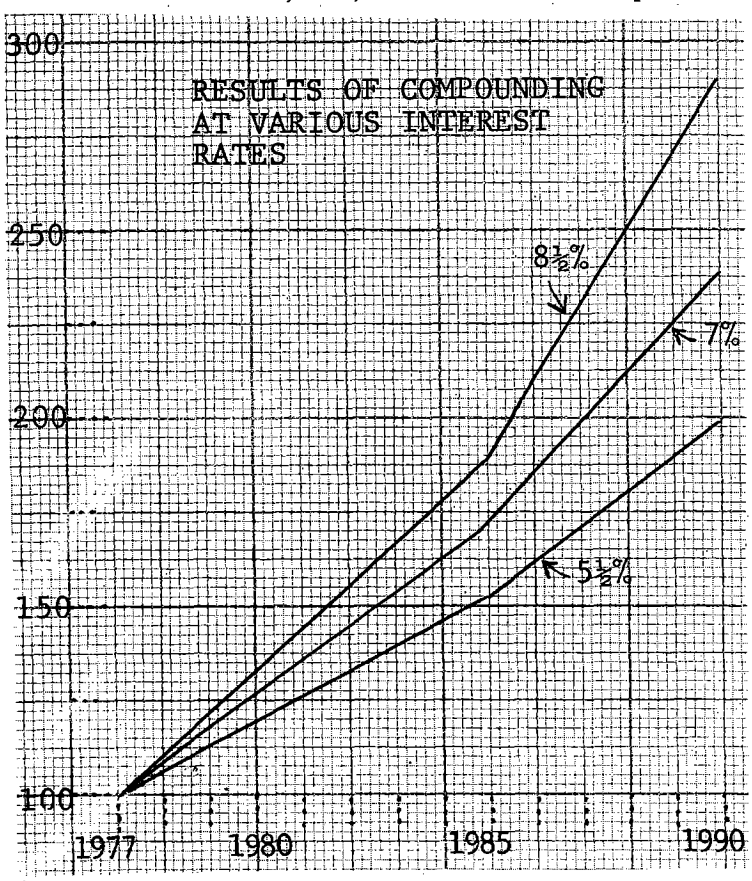
My feeling is that this portion of the second phase of the bull market represents a **period of adjustment.** Kodak and MMM have been sliding while the "value stocks" have been rising. Bonds have become popular, and at least a few institutional managers have realized that a stock yielding 2% has to quadruple its dividend before it pays you what an Aa bond yielding 8% can pay you now.

Thus the emphasis on yield now, not glamor, is going to continue until the adjustment is over, until the glamor stocks and over-priced pampered beauties have come down to a value basis, and until Wall Street is satisfied that the market is on a rock-hard base of earnings and yields.

THEY KNOW: The title of this section, of course, should have been "What the pension managers (hopefully) know," or "What every individual buyer of tax-free bonds should know."

I have been trying for the past year-and-a-half to show subscribers why high interest rates, when compounded, can make people rich. Interest rates have come down over the past few months, but many fixed-income securities still offer high and attractive yields. For the higher-income individual investor the place to compound your money is the municipal bond fund. For the pension plan (where interest and dividends are deferred) a large percentage of assets and new money should go into bonds, where high yield and safety is a feature.

I have drawn a little chart which will serve to show what happens to $100 (interest compounded yearly) when invested at three common rates of interest, 5½%, 7% and 8½%. The time spans I have used are 8 years (or the year 1985) and 13 years (or the year 1990).



Note that even at the 5½% rate which is the lowest rate, your money will double by 1990. The 5½% rate is readily available today from tax-free municipal bonds and from muni-bond funds. The 7% rate is available from Government bonds, and here your $100 will be $250 by 1990. Finally, the 8½% rate (readily available from preferred stocks and many good quality bonds) will compound to almost $290 by 1990.

Now I'll be brutally frank. Stocks go up and they go down, bull markets come and go and bear markets come and go. But the average fund or fund manager will probably not be able to match (much less surpass) the performance of the investment which is compounded at the 8½% rate over any reasonable length of time. Why do I make this cynical statement? I make it on the basis of experience and on my knowledge of investment ability. The average fund will tend to do alright until that inevitable bear market comes along, and then it will sustain a decline which will tend to wipe out a good part of the bull market gains. So before the fund is finished with the smart moves and the mistakes, I doubt that the money invested today is going to match the 8½% line on the chart carried through to 1990.

Question: Those rates of increase look fine, but what about inflation? How do I keep my purchasing power if inflation flares up to a 12% rate?

Answer: When inflation comes in at a 10% or a 12% rate, very few people win. Then it's just a case of losing as little as you can. But remember this, the US is no Brazil or Costa Rica. This country has huge capital markets, and those markets will buckle and collapse if inflation heats up and interest rates rise correspondingly (which they will). Thus, the US has an automatic deflator in that rising inflation brings a cave-in in the capital markets, and when the bonds go, the stock market goes. Furthermore, the stock market is very aware of the bond market today, and stocks are more sensitive to bonds now than was the case in 1950 or 1960.

Question: Alright, but how much of one's assets would you keep in bonds?

Answer: That's a personal decision, but as a broad attempt at an answer, I would like to keep 50% or more in bonds. For investors over 60 years of age, the ratio should probably be more like 75% or 80% in bonds.

Question: If you think professional fund managers won't do as well as the top line on your chart, why should we hold any common stocks? Why should we think we can beat 8½% compounded?

Answer: I don't know whether we can. Maybe I'm being arrogant or maybe I'm indulging in wishful thinking, but I think correct investment procedure (as far as I'm concerned) is to be invested with the primary trend of the market. Since this is a bull market, I want my subscribers to have up to 50% of their assets in common stocks. If interest rates on money instruments were lower, I would probably want my subscribers to be at least 75% invested in common shares.

TECHNICAL PICKINGS: The British market (now over 400) has recovered better than 90% of its fantastic 1976-77 drop (which was 420 to 165 on the Financial Times index of 30 Industrials). The recovery has been amazing, and it should be a big plus for the US market. Historically, the two markets tend to follow each other, and the British come-back has been one of the most sensational in history. Furthermore, British bonds have staged a great rally. Britannia may not "rule the waves" any more but their stock market, at least, is still floating!

My own *Primary Trend Index (PTI)*, as seen on the page 3 chart, is still within a few points of its bull market high. The PTI is made up of 8 critical indices and averages. These 8 provide a running picture of the technical condition of the market. If anything, the PTI has been slightly stronger than the A-D Ratio. I cannot picture a market slide without the PTI sagging, either before a Dow top or coincidentally with a Dow top. All I can say is that the PTI is certainly **not** sagging yet. And with a good day or two, it could be at a new high above the January 25 bull market peak of 834!

The odd lot shorts are now coming in at their highest rate since October, 1975. This is the first time in 15 months that the odd lot short has been willing to "bet on the downside" to the tune of over 5,000 shares a day. The odd lot shorts jibe with the regular odd lot traders, who have been increasing their rates of sales (over purchases) for the past 10 days. Both developments are constructive for the trend of the market.

Much is being made of the so-called "Decennial Pattern" in the market, which attempts to show how certain years tend to produce advances and others declines. For instance, the "7 years" are known as bad years. In checking the 14 completed decennial periods beginning with 1831 to 1840, I noted that 10 of the years ending in 7 were down but 4 were up. The 4 up-years were 1847, 1897, 1927 and 1967.

In other words, 18% of the 7 years were up and 72% were down. To my mind, that's **not** a conclusive showing. On the basis of the past, one can say that there is a 3.5 to 1 chance that 1977 will be a down year. But you can also say that because 72% of the **past** 7-years were down, the odds favor an equalizing process, with 1977 being an up year. In all, I feel that the decennial approach is about worthless.

LATE NOTES: I don't want subscribers to take the "insurance" section at the beginning of this report as a bearish omen from me. It's no more bearish than a man taking out a life insurance policy. But I did want subscribers to realize that there are safety devices in the market, and I'm not adverse (or too stubborn) to use them.

As this is written (Feb. 2) the market is attempting to get a rally going, and what impresses me most is (1) the fact that the Transports are **still 26 points above** their critical 203.85 low, (2) the fact that the A-D Ratio is still within 1 point from its bull market peak, (3) the fact that my PTI is within 6 points of a new bull market high, which means that it could actually hit a new high if today winds up as a big one on the upside! All of this has occurred in the face of the worst weather news since the Blizzard of '88, and in the face of a rise in money rates. So far, I have to call it an extraordinary performance.

Conclusion: Let's continue to "sit tight." It's a primary bull market, and time should be working with us. Tonight President Carter speaks. Tomorrow Fed Chairman Burns speaks. I would guess that both are going to sound "encouraging," but the market will probably want to wait and see for itself.

One of the tests I put to myself is this: "How would I feel if I was sitting with about ten assorted short positions?" My answer today is that I would be sweating profusely, and wanting to cover. That means that my gut feeling is that the short side of the market is a dangerous one today. If the short side is the dangerous one, then there's a good chance that the long side is the right one. Any way, that's the Russell gut-test in action!

ITEMS: For whatever reasons, the men who have worked with and written about the Dow Theory have not lived to be old men. Dow did not, William Hamilton did not, Robert Rhea died rather early, and E. George Shaefer was not an old man when he died.

A local psychic (of considerable fame) recently told me that I would "live to be a very old man." Although Americans in general do not honor old age (the way the Chinese do, for instance), I happen to like the idea of living to be 100 or so. But to get there, you have to take a lot of the insanity out of your life. I've been trying to do that for quite some time.

When I first started in this business, I made it a point to answer every letter. I tried to see every person who called, arrived without calling or just descended. I've had to give up that approach. There are too many subscribers now, and it's either "cool it" or drop dead at nearer 50 than 100. I'm still shooting for the higher figure. SO.....once again, I'm going to offer my apologies for all those whose letters I cannot answer and all those who are in La Jolla and want to "see if that kook is for real." I would really love to see all my subscribers, but I can't do it.

I don't know why this interests me but it does. Mr. David C. Levy, Dean of the highly respected Parsons School of Design recently made up his list of the 10 most beautifully designed cars of the past 50 years. For the 1930's it was the '31 Duesenberg and the '31 Bugatti Royale. For the '40's it was the MG Model TC and the '40 Delahaye. For the '50's it was the '55 Rolls "Silver Dawn" and the '54 Ford Thunderbird. For the '60's we have the Jaguar XKE and the Type 600 Mercedes. And for the '70's Levy nominates the Porsche 914 and the '76 Cadillac Seville.

As sure as night follows day, the age of "the end of waste" is coming. We had hamburgers and coffee in McDonald's the other day, and I think we must have thrown away a pound of assorted napkins, cardboard, wax papers and plastic cups. I never saw such an obscene waste of materials. It's going to end. We're flushing America down the drain and into the garbage pails. By the same token, I believe it's only a matter of time before natural gas and gasoline are decontrolled. When gas is $1.50 to $2.50 a gallon (as it is everywhere else in the world), people will cease taking a 3,500 pound metal monster to the corner to pick up a pack of cigarettes.

Our leaders are obviously aware of the need for savings. In the past few weeks, President Carter has cut down on the Washington DC limousine corps. And California's Governor Brown has put a special water-savings sprinkler on his shower and a low-pressure flusher on his toilet (I'm serious). Now for the big savings.....

A *Forbes* (Feb. 1) article tells about foreign money pouring into Houston. The piece quotes a Texas executive on why German money has zeroed in on Texas (over $200 million in Houston alone last year): "Foreigners with money see New York going bankrupt, Florida overbuilt, California full of kooky environmentalists, and Oregon and Colorado clamoring about no growth: we look pretty attractive."

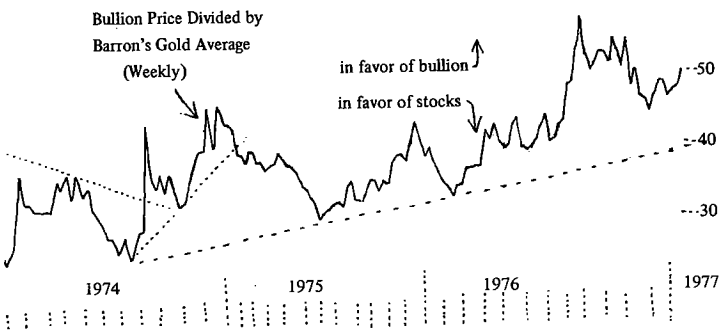
Incidentally, the fastest disillusionment in history regarding a new President probably occurred during the Hoover inaugural in 1929. The editors at the Chicago Tribune were listening to the inaugural speech. Halfway through the speech they received a telegram from their ferociously conservative publisher, Col. Robert McCormick. It said,"This man Hoover won't do!"

I just received "Industry Forecast" from Mr. S. Jay Levy (Box Chappaqua, NY 10514). I have always considered Levy an absolutely top economic forecaster, and after meeting him a few months ago in NYC I'm more impressed than ever. At any rate, he starts his latest report, "Hefty advances at the end of 1976 by industrial production and retail sales were harbingers of a strong trend towards prosperity in 1977. Corporate profits will be 20% higher than in 1976." Previously, Levy had estimated that corporate profits "would increase by at least 15%."

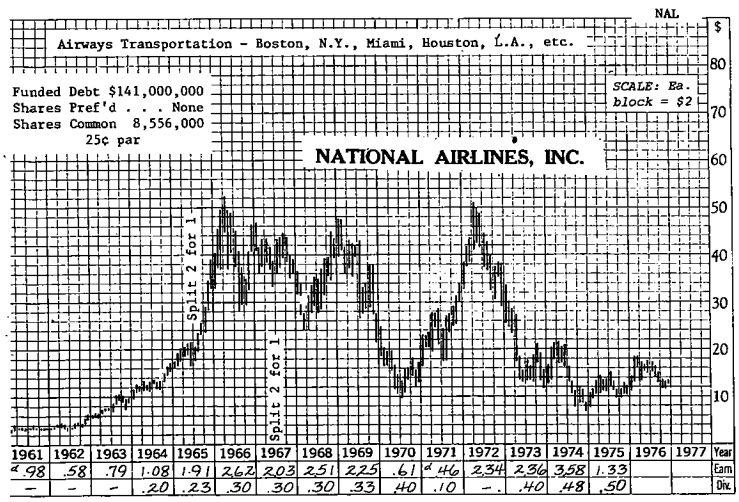
GOLD: My basic opinion regarding gold has not changed. As long as gold fails to better the 138.85 mark, I would leave it alone. As long as gold fluctuates between 121 and 138.85, it is "telling us nothing" from a technical standpoint.

There's a lot of nonsense currently being written about gold and gold mines. Some months ago I published a chart showing that the Gold Stock Group had blown its top during 1974 on a relative strength basis. Following such areas of **distribution**, it can take a decade or more before the group "comes back" into investor favor. I rather suspect that gold followers are faced with that possibility now. The stocks were distributed during 1974 and early 1975. They're not going to come back for quite a while.

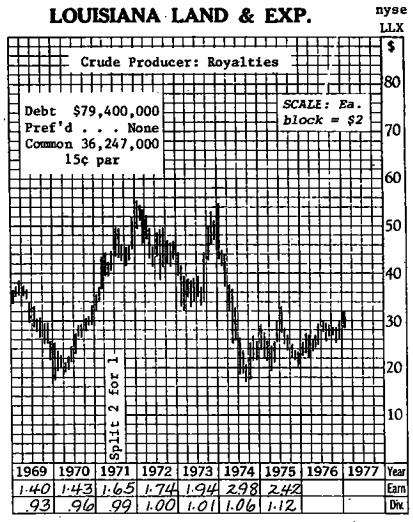
One phenomenon is for sure. I say it's for sure because I can prove it via my chart. The preference since mid-1974 has been to bullion, rather than the stocks. This chart shows the ratio of gold (weekly) to Barron's Gold Average (which is heavily weighted for ASA). That ratio has been moving up steadily in favor of gold. There's no debate or interpretation here, it's happening, brother. Noting this trend, I have consistently advised since 1975 that any gold position be in the area of gold bullion, not the shares. I am still of that mind. If you like gold, buy Krugerrands. If you like gold shares, then all I can say is that you are not dealing with reality as it appears on my chart.



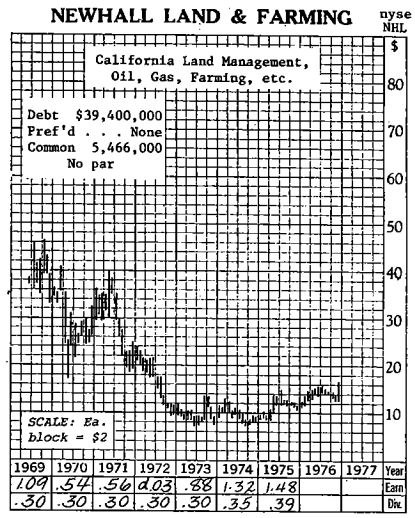
STOCKS: Subscribers who have been following these reports should have all the stocks they need. But here are a few which deserve mentioning. Everything is coming up "energy" these days, and it's probably just beginning. If it isn't energy, it's probably going to be "assets." At any rate, Louisiana Land is a number which sold as high as 55 back in 1971. S&P estimates that this crude producer can earn $3.10 in 1977. Roughly, 98% of LLX's assets are in the US, which is a big plus these days. The stock is just moving out of a two year base. I like it.



Newhall Land buys you a piece of California action, even if you don't want to actually move here. About 35% of this stock can be considered an asset play, with the rest in amusement parks, farming, etc. The stock is coming out of a four year base, and it just could be an interesting number.



With the Transports holding well, I am looking at National Airlines. They loved NAL at 50 in 1972, and now with the stock at around 11 I'm interested in it. NAL pays a 50 cent dividend, and S&P did estimate earnings of $1.50 for '77. I would lower those earnings somewhat because of the rotten weather (who needs to go to Miami and freeze?) Relative strength has been quietly creeping up for the Airlines since mid-1975. NAL looks like value to me, and it's still only a few points off its 1974 bear market low. (Charts this page courtesy of HORSEY).


NEWHALL LAND & FARMING
nyse
NHL
California Land Management,
Oil, Gas, Farming, etc.
Debt $39,400,000
Pref'd . . . None
Common 5,466,000
No par
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CALIFORNIA: I don't know, sometimes these reports are easy to write, and sometimes they're a devil. This one has been a SOB, for some reason, so I'll try to end it with a smile. After reading about the weather around the country for the past month, I'm really embarrassed to talk about our weather here. Put it this way, I still don't own an overcoat.

But the Golden state is not perfect. For instance, you can't see a movie these days without witnessing a scene in which one or more police squad cars are demolished. It's some sort of a fad or craze. But where else but in California would some weirdo try to demolish an entire police station! It happened out here last week!

BURBANK (UPI) — James Fogelsong was arrested for entering a police station.

Officers felt he should have left his car outside.

Police said Fogelsong, 19, was at the wheel of an auto that jumped a curb and crashed into the door of the station last week, smashing through a double glass door and an 8-by-15 foot glass window into the building's lobby.

Fogelsong was arrested for drunken driving.

NEXT MAILING: February 18th